A Report
to the
Montana
Legislature

Financial Audit

Montana State Fund

For the Two Fiscal Years Ended June 30, 2011

December 2011

Legislative Audit
Division

10-05B

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LEGISLATIVE AUDIT DIVISION

Tori Hunthausen, Legislative Auditor
Deborah F. Butler, Legal Counsel

Deputy Legislative Auditors
Cindy Jorgenson
Angie Grove

December 2011

The Legislative Audit Committee
of the Montana State Legislature:

This is our financial audit report of the Montana State Fund, a component unit of the state of Montana, for the two fiscal years ended June 30, 2011. The statements include comparative information for the fiscal year ended June 30, 2010. We made no recommendations to the Montana State Fund in the prior audit report. This report contains no recommendations. On page A-1, you will find the independent auditor's report. We issued an unqualified opinion on the financial statements, which means the reader can rely on the information presented.

Montana State Fund's response to our audit is on page B-1. We thank the Montana State Fund staff for their cooperation and assistance during the audit.

Respectfully submitted,

Tori Hunthausen, CPA
Legislative Auditor

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STATE FUND RESPONSE
Montana State Fund B-1

Appointed and Administrative Officials

Montana State Fund	Laurence Hubbard, President/CEO	
	Mark Barry, Vice President, Corporate Support	
	Richard Duane, Vice President, Human Resources	
	Richard Root, Vice President, Insurance Operations	
	Peter Strauss, Vice President, Insurance Operations Support	
	Nancy Butler, General Counsel	
	Al Parisian, Chief Information Officer	
State Fund Board of Directors		Term Expires
	Elizabeth Best, Chair	2015
	Joe Brenneman	2015
	Jane Debruycker	2013
	Wayne Dykstra	2015
	Thomas R. Heisler	2013
	Ken Johnson	2013
	James Swanson	2013

For additional information concerning the Montana State Fund contact:

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Montana Legislative Audit Division

Financial Audit
Montana State Fund
For the Two Fiscal Year Ended June 30, 2011

December 2011 | 10-05B | Report Summary

Montana State Fund (MSF) accounts for claims incurred on or after July 1, 1990, (New Fund) separately from claims incurred prior to July 1, 1990, (Old Fund). Adequate funding of the Old Fund is the responsibility of the state of Montana's General Fund. By fiscal year-end 2010-11, the Old Fund liquidated all of its assets and received a $50,000 transfer from the General Fund to pay claims. Payment of the Old Fund liabilities in the amount of approximately $64 million is now the responsibility of the General Fund.

Context

MSF is administratively attached to the state of Montana, Department of Administration. MSF is governed by a seven member board of directors appointed by the Governor. The MSF is a nonprofit, independent public corporation established under Title 39, chapter 71 of the Montana Code Annotated. MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employees in Montana.

In fiscal year 2010-11, MSF premiums were approximately $174 million and claims were approximately $151 million. Active policies decreased from approximately 25,253 to 24,780 as of June 30, 2010, and 2011. MSF paid dividends to policyholders of $4 million in fiscal year 2010-11. In addition, MSF accrued $1.1 million at June 30, 2011, to pay its employees an incentive for meeting certain benchmarks. The incentive payments were made to employees in November 2011.

Results

There are no recommendations to the MSF in the current audit report.

Recommendation Concurrence	
Concur	0
Partially Concur	0
Do Not Concur	0

Source: Agency audit response included in final report.

For a complete copy of the report (10-05B) or for further information, contact the Legislative Audit Division at 406-444-3122; e-mail to lad@mt.gov; or check the web site at http://leg.mt.gov/audit
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Call toll-free 1-800-222-4446, or e-mail lad@mt.gov.

Chapter I – Introduction

Introduction

We performed a financial audit of the Montana State Fund (MSF) for the two fiscal years ended June 30, 2011.

The objectives of this audit were to:

1. Determine whether MSF complied with selected applicable laws and regulations.
2. Obtain an understanding of the MSF's control systems to the extent necessary to support our audit of MSF's financial statements, and if appropriate, make recommendations for improvement in management and internal controls of MSF.
3. Determine whether the MSF's financial statements present fairly the financial position, results of operations, and cash flows for the fiscal year ended June 30, 2011, with comparative financial amounts for the fiscal year ended June 30, 2010.

MSF personnel prepared the financial statements from the Statewide Accounting, Budgeting, and Human Resources System with adjustments. Adjustments are made to present financial activity in accordance with generally accepted accounting principles. This report contains no recommendations and the prior audit also contained no recommendations.

Background

Montana State Fund is a nonprofit, independent public corporation that provides Montana employers with an option for workers' compensation and occupational disease insurance, and guarantees available coverage for all employees in Montana. Montana State Fund is governed by a seven-member board of directors appointed by the Governor. State law separates funding sources for claims incurred before July 1, 1990, (Old Fund) and those incurred on or after July 1, 1990, (New Fund).

Montana State Fund management must set premium rates for the New Fund at amounts sufficient, when invested, to carry the estimated cost of all claims to maturity, to meet the reasonable expenses of conducting the business of the New Fund, and to maintain a surplus over the amount produced by the National Association of Insurance Commissioners' risk-based capital requirements for a casualty insurer. The Old Fund costs were funded primarily by investment earnings and investment principal in fiscal year 2010-11. Old Fund assets were insufficient to pay all claims that became due or payable during fiscal year 2010-11; therefore, as required by law, the state General

Fund provided the funding necessary to pay the remaining due and payable claims for the year. This funding amounted to $50,000. The investments of the Montana State Fund are managed by the Montana Board of Investments and invested according to policies established in law.

Independent Auditor's Report and Montana State Fund Financial Statements

LEGISLATIVE AUDIT DIVISION

Tori Hunthausen, Legislative Auditor
Deborah F. Butler, Legal Counsel

Deputy Legislative Auditors
Cindy Jorgenson
Angie Grove

Independent Auditor's Report

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the accompanying Statement of Net Assets of the Montana State Fund, a component unit of the state of Montana, as of June 30, 2011, and 2010, and the related Statement of Revenues, Expenses, and Changes in Fund Net Assets, and Statement of Cash Flows, for each of the fiscal years then ended. The information contained in these financial statements is the responsibility of Montana State Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the Montana State Fund as of June 30, 2011, and 2010, and the respective results of operations and cash flows for each of the fiscal years then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying Management's Discussion and Analysis, Schedule of Funding Progress and Risk Management Trend Information for Montana State Fund are not required parts of the financial statements, but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Respectfully submitted,

Cindy Jorgenson, CPA
Deputy Legislative Auditor

November 18, 2011

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Montana State Fund
(A Component Unit of the State of Montana)
Management Discussion and Analysis
June 30, 2011 and 2010

Overview of the Financial Statements

This overview is an introduction to Montana State Fund (MSF) financial statements. The financial statements consist of two components: (1) basic financial statements, and (2) notes to the basic financial statements.

The statement of net assets presents information regarding all of MSF's assets and liabilities, with the difference between the two being reported as net assets.

The statement of revenue, expenses, and changes in fund net assets present the financial results of operations for MSF for the two most recent fiscal years. This statement presents information showing how the net assets changed during the two most recent fiscal years. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of the cash flows. Thus, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods.

The statement of cash flows details the cash used and provided by the various activities of MSF during the fiscal year. However, this statement does not consider unpaid responsibilities which have been established by contract or other underlying events during the fiscal year.

The following analysis presents two years of comparative condensed financial data for MSF.

A-4 **Analysis of Financial Position**

The following is a comparison of the financial position of MSF at June 30, 2011 to 2010, (In thousands):

	6/30/2011	6/30/2010	Change
Assets:			
Cash and STIP	$ 19,715	$ 28,149	$ (8,434)
Investments	1,203,149	1,102,416	100,733
Security Lending Collateral	89,190	167,515	(78,325)
Receivables (Net)	58,105	63,970	(5,865)
Capital Assets (Net)	34,720	37,719	(2,999)
Other Assets	49,059	62,626	(13,567)
Total Assets	$ 1,453,938	$ 1,462,395	$ (8,457)
Liabilities:			
Loss and LAE Reserves	$ 874,803	$ 838,765	$ 36,038
Liability for Securities on Loan	89,190	167,515	(78,325)
Payables	15,282	19,590	(4,308)
Other Liabilities	104,134	119,649	(15,515)
Total Liabilities	1,083,409	1,145,519	(62,110)
Net Assets:			
Investment in Capital Assets	34,720	37,719	(2,999)
Unrestricted Net Assets	335,809	279,157	56,652
Total Net Assets	370,529	316,876	53,653
Total Liabilities and Net Assets	$ 1,453,938	$ 1,462,395	$ (8,457)

Net Assets increased approximately $53.7M (million) in fiscal year 2011 compared to fiscal year 2010, primarily due to unrealized gains on investments. Loss and LAE Reserves increased by $36.0M. The increase is due to recording another accident year of losses and an increase in the LAE rate. Cash and Short-term investment pool (STIP) and Investments increased by $92.3M in comparison to a $106.0M increase in the previous fiscal year (as shown in the table below). Remaining assets decreased $100.8M and other liabilities decreased $98.1M, which is mainly driven by the change in the securities lending balances.

For the fiscal year ended June 30, 2011, MSF financial statements include $1.14M in land and $27.4M in buildings. (Note 1- Other Assets in the Notes to the Financial Statements provides additional information.)

The change in market value of MSF's investment portfolio of fixed and equity securities in fiscal year 2011 was as follows, (In thousands):

Fiscal Year 2010 Market Value	$ 1,102,416
Purchases at Cost	217,506
Sales	(154,964)
Net Realized Gains	6,425
Net Accretion of Bonds	9
Unrealized Gain (Loss)	31,758
Fiscal Year 2011 Market Value	$ 1,203,149

Towers Watson, an independent actuarial firm, prepares an actuarial study used to estimate liabilities, including claim adjustment expenses and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2011 and June 30, 2010. Towers Watson provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected a central estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2011 and 2010. The estimated claims payable is presented undiscounted, net of estimated reinsurance recoverable, at $874.8M and $838.8M, as of June 30, 2011, and June 30, 2010, respectively.

MSF restated fiscal year 2009 to establish the correct recording of written premium in the statement of operations. The receivable for unbilled premium receivable and the liability for unearned premium were recorded as restated amounts for fiscal year 2009 with an adjustment to equity in the amount of $3.4M.

The following is a comparison of the financial position of MSF at June 30, 2010 to June 30, 2009 (Restated), (In thousands):

	6/30/2010	6/30/2009 (Restated)	Change
Assets:			
Cash and STIP	$ 28,149	$ 31,389	$ (3,240)
Investments	1,102,416	993,222	109,194
Security Lending Collateral	167,515	175,758	(8,243)
Receivables (Net)	63,970	69,129	(5,159)
Capital Assets (Net)	37,719	19,890	17,829
Other Assets	62,626	50,287	12,339
Total Assets	$ 1,462,395	$ 1,339,675	$ 122,720
Liabilities:			
Loss and LAE Reserves	$ 838,765	$ 813,305	$ 25,460
Liability for Securities on Loan	167,515	175,758	(8,243)
Payables	19,590	17,825	1,765
Other Liabilities	119,649	111,796	7,853
Total Liabilities	1,145,519	1,118,684	26,835
Net Assets:			
Investment in Capital Assets	37,719	19,890	17,829
Unrestricted Net Assets	279,157	201,101	78,056
Total Net Assets	316,876	220,991	95,885
Total Liabilities and Net Assets	$ 1,462,395	$ 1,339,675	$ 122,720

Net Assets increased approximately $95.9M in fiscal year 2010 compared to fiscal year 2009. Loss and LAE Reserves increased by $25.5M due to recording another accident year of losses. Total Assets increased $122.7M which includes an increase in Cash, STIP and Investments by $106.0M, a decrease in Security Lending Collateral of ($8.2M). Total Liabilities increased by $26.8M which includes an increase in Loss and LAE Reserves of $25.5M, a decrease in Liability for Securities on Loan of ($8.2M).

MSF management selected a central estimate within the range established by Towers Watson as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2010 and 2009. The estimated claims payable was presented undiscounted, net of estimated reinsurance recoverable, at $838.8M and $813.3M, as of June 30, 2010, and June 30, 2009, respectively.

The change in market value of MSF's investment portfolio of fixed and equity securities in fiscal year 2010 was as follows, (In thousands):

Fiscal Year 2009 Market Value	$ 993,222
Purchases at Cost	219,627
Sales	(186,920)
Net Realized Gains	2,183
Net Accretion of Bonds	345
Unrealized Gain (Loss)	73,958
Fiscal Year 2010 Market Value	$ 1,102,416

Results of Operations

The following is a comparison of MSF's results of operations for fiscal year 2011 to fiscal year 2010, (In thousands):

	6/30/2011	6/30/2010	Change
Operating Revenues:			
Net Premium Earned	$ 173,605	$ 166,265	$ 7,340
Total Operating Revenue	173,605	166,265	7,340
Operating Expenses:			
Benefits and Claims	150,680	153,095	(2,415)
Personal Services	24,454	22,716	1,738
Other Operating Expense	23,747	13,589	10,158
Total Operating Expense	198,881	189,400	9,481
Net Operating Income (Loss)	(25,276)	(23,135)	(2,141)
Nonoperating Revenue (Expense):			
Investment Income	81,074	120,519	(39,445)
Other Nonoperating Revenue	1,859	503	1,356
Dividend Expense	(4,005)	(2,001)	(2,004)
Total Nonoperating Revenue (Expense)	78,928	119,021	(40,093)
Change in Net Assets	$ 53,652	$ 95,886	$ (42,234)

MSF's book of business increased approximately 4% from $166.3M of net earned premium in fiscal year 2010 to $173.6M of net earned premium in fiscal year 2011 as a result of increased payroll being reported by policyholders.

MSF paid dividends to policyholders of $4.0M in fiscal year 2011 and $2.0M in fiscal year 2010. The Board of Directors, at its discretion, recommends the amount of dividends to be declared.
Investment income decreased by ($39.4M) in fiscal year 2011 over investment income in fiscal year 2010. This decrease was primarily due to net unrealized losses on investments of ($42.2M), a decrease in long term bond income of ($1.5M) and a net realized gain of $4.2M.

The following is a comparison of MSF's results of operations for fiscal year 2010 to fiscal year 2009 (restated), (In thousands):

	6/30/2010	6/30/2009 (Restated)	Change
Operating Revenues:			
Net Premium Earned	$ 166,265	$ 203,976	$ (37,711)
Total Operating Revenue	166,265	203,976	(37,711)
Operating Expenses:			
Benefits and Claims	153,095	185,514	(32,419)
Personal Services	22,716	22,138	578
Other Operating Expense	13,589	18,576	(4,987)
Total Operating Expense	189,400	226,228	(36,828)
Net Operating Income (Loss)	(23,135)	(22,252)	(883)
Nonoperating Revenue (Expense):			
Investment Income	120,519	17,306	103,213
Other Nonoperating Revenue	503	2,013	(1,510)
Dividend Expense	(2,001)	(3,997)	1,996
Total Nonoperating Revenue (Expense)	119,021	15,322	103,699
Prior Year Correction (Restated)	0	3,369	(3,369)
Change in Net Assets	$ 95,886	$ (3,561)	$ 99,447

MSF's book of business decreased 18.5% from $204.0M of net earned premium in fiscal year 2009 to $166.3M of net earned premium in fiscal year 2010. The economic conditions caused a decline in the amount of payroll reported by policyholders. Montana's unemployment rate increased from 6.7% in June 2009 to 7.4% in June 2010.

MSF paid dividends to policyholders of $2.0M in fiscal year 2010 and $4.0M in fiscal year 2009. The Board of Directors, at its discretion, recommends the amount of dividends to be declared.

Investment income increased by $103.2M in fiscal year 2010 over investment income in fiscal year 2009. This increase was primarily due to unrealized gain on investments as MSF experienced an unrealized gain of \$74.0M in fiscal year 2010, compared to an unrealized loss on investments of (\$15.1M) in fiscal year 2009. Total net realized gains on investments for fiscal year 2010 were \$2.2M compared to (\$13.6M) net realized losses reported in fiscal year 2009.

Montana State Fund
Statement of Net Assets
Montana State Fund is a component unit of the State of Montana

June 30,	2011	2010
ASSETS		
Current Assets		
Cash and Cash Equivalents	$ 19,715,216	$ 28,148,675
Receivables, Net	58,105,262	63,970,492
Securities Lending Collateral	89,189,742	167,514,931
Other Assets	5,536,089	5,561,661
Total Current Assets	172,546,309	265,195,759
Noncurrent Assets		
Investments	1,203,148,728	1,102,415,833
Reinsurance Receivables	43,523,117	57,063,883
Equipment, Net	3,365,080	4,262,927
Land	1,139,460	1,139,460
Buildings, Net	27,368,419	27,793,885
Construction Work in Progress	500,000	-
Intangible Assets	2,346,907	4,523,222
Total Noncurrent Assets	1,281,391,711	1,197,199,210
Total Assets	$ 1,453,938,020	$ 1,462,394,969
LIABILITIES		
Current Liabilities		
Accounts Payable	$ 15,281,660	$ 19,573,080
Due to Primary Government	-	16,981
Estimated Claims Payable	109,287,428	113,547,592
Compensated Absences	1,228,717	928,022
Securities Lending Liability	89,189,742	167,514,931
Unearned Premium	37,369,134	47,054,326
Policyholder Deposits	2,775,270	3,245,060
Total Current Liabilities	255,131,951	351,879,992
Noncurrent Liabilities		
Estimated Claims Payable	765,515,456	725,217,748
Reinsurance Funds Withheld	57,887,750	64,235,976
Compensated Absences	1,469,122	1,622,553
Other Post Employment Benefits	3,404,954	2,561,741
Total Noncurrent Liabilities	828,277,282	793,638,018
Total Liabilities	1,083,409,233	1,145,518,010
NET ASSETS		
Invested in Capital Assets, Net of Related Debt	34,719,867	37,719,494
Unrestricted	335,808,920	279,157,465
Total Net Assets	370,528,787	316,876,959
Total Liabilities and Net Assets	$ 1,453,938,020	$ 1,462,394,969

The notes to the financial statements are an integral part of this statement.

Montana State Fund
Statement of Revenues, Expenses, and Changes in Fund Net Assets
Montana State Fund is a component unit of the State of Montana

YEAR ENDED JUNE 30,	2011	2010
Net Premiums Earned	$ 173,605,442	$ 166,265,384
Operating Expenses		
Benefits and Claims	150,680,148	153,094,853
Personal Services	24,453,933	22,716,285
Contractual Services	10,833,929	1,087,974
Supplies and Materials	578,162	1,083,989
Depreciation	1,513,752	410,496
Amortization	2,176,315	2,093,322
Rent and Utilities	521,273	440,495
Communications	1,318,869	1,551,777
Travel	187,737	195,219
Repair and Maintenance	1,419,999	1,352,644
Other Operating Expenses	5,197,420	5,372,709
Total Operating Expenses	198,881,537	189,399,763
Operating Income (Loss)	(25,276,095)	(23,134,379)
Nonoperating Revenue(Expenses)		
Investment Income	81,074,233	120,518,771
Securities Lending Income	1,163,869	950,244
Securities Lending Expenses	(320,544)	(394,677)
Penalties and Interest	22,901	42,968
Gain (Loss) on Retirement of Assets	14,465	(114,667)
Dividend Expense	(4,004,521)	(2,001,293)
Other Income	36,539	19,624
Payment from State of Montana	940,981	-
Total Nonoperating Revenue(Expenses)	78,927,923	119,020,970
Change in Net Assets	53,651,828	95,886,591
Total Net Assets - Beginning	316,876,959	220,990,368
Total Net Assets - Ending	$ 370,528,787	$ 316,876,959

The notes to the financial statements are an integral part of this statement.

Montana State Fund
Statement of Cash Flows
Montana State Fund is a component unit of the State of Montana

YEAR ENDED JUNE 30,	2011	2010
Cash Flows from Operating Activities		
Receipts for Premiums	175,074,500	170,059,904
Payments to Suppliers for Goods and Services	(21,811,822)	(6,876,130)
Payments to Employees	(22,000,357)	(22,500,111)
Cash Payments for Claims	(115,864,848)	(126,954,464)
Other Operating Receipts	59,439	62,592
Net Cash Provided by (Used for) Operating Activities	15,456,912	13,791,791
Cash Flows from Noncapital Financial Activities		
Payment of Dividends to Policyholders	(4,004,521)	(2,001,293)
Net Cash Provided by (Used for) Noncapital Financing Activities	(4,004,521)	(2,001,293)
Cash Flows from Capital and Related Financing Activities		
Acquisition of Fixed Assets	(499,817)	(20,290,188)
Proceeds from Sale of Fixed Assets	14,465	(114,667)
Net Cash Used for Capital and Related Financing Activities	(485,352)	(20,404,855)
Cash Flows from Investing Activities		
Purchase of Investments	(217,505,513)	(226,680,416)
Proceeds from Sales or Maturities of Investments	154,963,930	186,920,005
Proceeds from Securities Lending Transactions	1,163,869	950,245
Payments of Security Lending Costs	(333,129)	(363,337)
Interest and Dividends on Investments	42,310,345	44,547,520
Net Cash Provided by (Used For) Investing Activities	(19,400,498)	5,374,017
Net Increase (Decrease) in Cash and Cash Equivalents	(8,433,459)	(3,240,340)
Cash and Cash Equivalents - July 1	28,148,675	31,389,015
Cash and Cash Equivalents - June 30	19,715,216	28,148,675

Montana State Fund
Statement of Cash Flows
Montana State Fund is a component unit of the State of Montana

YEAR ENDED JUNE 30,	2011	2010
Reconciliation of Change in Net Assets to Net Cash Provided by (Used for) Operating Activities		
Change in Net Assets	53,651,828	95,886,591
Adjustments to Reconcile Change in Net Assets to Net Cash Provided by (Used for) Operating Activities		
Depreciation	1,435,554	410,496
Amortization	2,063,890	2,093,322
Security Lending Costs	320,544	394,677
Security Lending Income	(1,163,869)	(950,244)
Income on Investments	(81,074,233)	(120,518,771)
Payments of Dividends to Policyholders	4,004,521	2,001,293
Decrease (Increase) in		
Accounts Receivable	6,437,807	4,054,866
Due from Component Units of the State of Montana	-	433,661
Due from Primary Government	-	-
Notes Receivable	-	-
Other Assets	11,107	1,604,969
Increase (Decrease) in		
Accounts Payable	(4,278,835)	10,193,310
Due to Primary Government	(16,981)	(1,295,253)
Unearned Premium	(9,685,192)	(4,497,353)
Property Held in Trust	(469,790)	(630,075)
Funds Withheld	7,192,541	(1,691,126)
Estimated Claims Payable	36,037,544	25,460,628
OPEB Liability	843,213	808,837
Compensated Absences	147,263	31,963
Total Adjustments	(38,194,916)	(82,094,800)
Net Cash Provided by (Used for) Operating Activities	15,456,912	13,791,791

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1. Summary of Significant Accounting Policies

Description of Business

The Montana State Fund (MSF) is a nonprofit, independent public corporation established under Title 39, chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. The Board has full power, authority, and jurisdiction in the administration of MSF as fully and completely as the governing body of a private mutual insurance carrier. MSF is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as MSF. Hereafter, any reference to MSF refers to the New Fund or those claims occurring after July 1, 1990.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. No State of Montana General Fund money is used for MSF operations. If MSF is dissolved by an act of law, the assets held by MSF are subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA). MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of funds and assets held by the Old Fund.

MSF financial statements are presented as a component unit in the State of Montana Comprehensive Annual Financial Report. The fiscal years 2011 and 2010 financial statements are presented in conformance with generally accepted accounting principles (GAAP), and Governmental Accounting Standards Board Statement 34 (GASB), which is a comparable format to the State of Montana Comprehensive Annual Financial Report.

Change in Reporting Entity

The assets of the Old Fund were completely liquidated in fiscal year 2011 and it is now fully supported by General Fund resources as required under state law (Section 39-71-2352, MCA). Therefore, beginning June 2011, the Old Fund is considered to be part of the Primary Government and is not included in the accompanying financial statements.

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Basis of Accounting

MSF uses the accrual basis of accounting, as defined by generally accepted accounting principles, for their workers' compensation insurance operations. Under the accrual basis, revenues are recorded in the accounting period earned, if measurable, and expenses are recorded in the period incurred, if measurable.

Cash and Cash Equivalents

Cash balances include demand deposits with the State Treasury. Cash equivalents are short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. MSF participates in the Montana Board of Investments Short Term Investment Pool (STIP). STIP balances are highly liquid investments with maturities of 397 days or less with the exception of securities having rate reset dates. The STIP portfolio is carried at amortized cost or book value with market value approximating cost. MSF's STIP balance of $14.9 (million) as of June 30, 2011, represents 0.61% of the total STIP. MSF's STIP balance of $22.8M as of June 30, 2010, represents 1.01% of the total STIP.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. The Montana Board of Investment's (BOI) policy requires that STIP investments have the highest rating in the short-term category by one of any Nationally Recognized Statistical Rating Organizations (NRSRO).

Investments

In addition to STIP investments, the BOI invests in long-term securities. Under the provisions of the state constitution, MSF invested assets are managed by the BOI. Securities are stated at fair value as defined and required by Governmental Accounting Standards Board (GASB) Statement 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools". Premiums and discounts are amortized using the straight-line method over the life of the securities. Net unrealized gains or losses on securities are included in net income in accordance with GASB 31.

The BOI follows the provisions of Governmental Accounting Standards Board (GASB) Statement No. 40 – Deposit and Investment Risk Disclosures. The investment risk disclosures are described in the following paragraphs.

Credit Risk

Credit risk is defined as the risk that an issuer or other counterparty to an investment will not fulfill its obligation. With the exception of the U.S. government securities, the State Fund fixed income instruments have credit risk as measured by major credit rating services. This risk

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is that the issuer of a fixed income security may default in making timely principal and interest payments. The Board of Investments' policy requires MSF fixed income investments, at the time of purchase, to be rated investment grade as defined either by Moody's or by Standard & Poor's (S&P) rating services. The investment policy, revised in May 2010, states "the maximum fixed income credit risk will be limited to 2% of the total securities portfolio in any one name". The U.S. government securities are guaranteed directly or indirectly by the U.S. government. Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk and do not require disclosure of credit quality. The credit ratings presented in the following table are provided by S&P's rating services. If an S&P rating is not available, a Moody's rating has been used.

Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. As of June 30, 2011 and 2010, all the fixed income and other equity securities were registered in the nominee name for the Montana Board of Investments and held in the possession of the Board's custodial bank, State Street Bank. The Equity Index investments were purchased in the State of Montana Board of Investments name.

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer. The Investment Policy requires credit risk to be limited to 2% in any one corporate name with "no limitation on U.S. government/agency securities". Investments issued or explicitly guaranteed by the U.S. government are excluded from the concentration of credit risk requirement.

The fiscal year 2011, the MSF concentration of credit risk is stated as 17.30% for combined investments in Federal Farm Credit Banks, Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corp. (Freddie Mac). For fiscal year 2010, MSF had concentration of credit risk exposure of 6.67% with Federal Home Loan Banks and 5.71% to the Federal National Mortgage Association (Fannie Mae).

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The Investment Policy sets an average duration range of 2-5 years for fixed income securities except in extraordinary circumstances where a shorter duration may be advisable. In accordance with GASB Statement No. 40, the Board has selected the effective duration method to disclose interest rate risk. This method, as provided by our analytics software, is "An option-adjusted measure of a bond's (or portfolio's) sensitivity to changes in interest rates. Duration is defined as the average percentage change in a bond's price for a given change in interest rates. Prices move inversely to interest rates. The effective duration method incorporates the effect of the embedded options for bonds and changes in prepayments for mortgage-backed securities (including pass-throughs, CMOs and ARMs)."

As of June 30, 2011, the MSF held one $10 million par synthetic Collateralized Debt Obligations (CDO) variable rate position in Aria II, 0.00%, 10/10/2012. A CDO is a security backed by a pool of bonds, loans or other assets. CDOs do not specialize in one type of debt but are often non-mortgage loans or bonds. A $4 million par CDO variable rate position in Galena 1, 5.060%, 01/11/2013, held as of June 30, 2009, was sold in May 2010. The MSF portfolios did not hold any structured financial instruments known as REMICs (Real Estate Mortgage Investment Conduits). REMICs are pass-through vehicles for multiclass mortgage-backed securities. The REMIC securities are based on separate or combined cash flows from principal and interest payments on underlying mortgages.

Corporate asset-backed securities are based on cash flows from principal and interest payments on underlying auto loan receivables, credit card receivables, or other assets. These securities, while sensitive to prepayments due to interest rate changes, have less credit risk than securities not backed by pledged assets.

As of June 30, 2011 and 2010, the MSF portfolio held three variable rate corporate bonds with $26 million par. The MSF variable-rate securities float with LIBOR (London Interbank Offered Rate).

The MSF investments are categorized below to disclose credit and interest rate risk as of June 30, 2011 and 2010. Credit risk reflects the bond quality rating, by investment type, as of the June 30 report date. If a bond investment type is unrated, the quality type is indicated by NR (not rated). Interest rate risk is disclosed using effective duration. The credit quality ratings have been calculated excluding cash equivalents.

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Credit Quality Rating and Effective Duration as of June 30, 2011

Security Investment Type		Fair Value	Credit Quality Rating	Effective Duration
Corporate Bonds (Rated)	$	643,878,319	A	3.45
Corporate Bonds (Unrated)		1,315,625	NR	(3.40)
U.S. Government Direct Obligations		209,446,080	AAA	4.52
U.S. Government Agency		210,719,306	AAA	3.38
STIP/SIVs (Unrated)		15,146,197	NR	
Total Fixed Income Investments		1,080,505,527		
Direct Investments				
Equity Index Fund-Domestic		120,542,240		
Equity Index Fund-International		16,990,000		
Total Equity Index Funds		137,532,240		
Total Direct Investments	$	137,532,240		
Total Investments	$	1,218,037,767	AA-	3.59

Legal and Credit Risk

As of June 30, 2011 and 2010, the Federal National Mortgage Association and Federal Home Loan Mortgage Corp. remain in conservatorship from September 7, 2008. Lehman Brothers filed for Chapter 11 bankruptcy on September 15, 2008. The MSF holds two positions of Lehman Brothers Holdings, Inc., $5 million par, 0.0%, 05/25/2010 and $4 million par, 5%, 01/14/2011. During fiscal year 2009, the Board wrote down the par value of these bonds. As of June 30, 2011 and 2010, these securities, due to write downs, report a book value of 20% of their original par value.

On October 30, 2008, the Board recognized collateral deterioration in the $4 million par position with the Galena CDO, 5.060%, 01/11/2013. As of June 30, 2009, this security was written down to a book value of 10% of its original par. In May 2010, this security was sold at a bond price of $36. In August 2011, S&P downgraded the U.S. AAA bond rating to AA+.

The following table presents the market values of the securities on loan and the total collateral held for fiscal years ended June 30, 2011 and 2010:

	2011	2010
Securities on Loan - Market Value	299,574,784	322,786,743
Total Collateral Held	306,415,876	330,199,605

Income earned related to securities on loan for MSF for the fiscal years ended June 30, 2011 and 2010 was \$1.2M and \$950K (thousand), respectively. Expenses related to securities on loan for MSF for the fiscal years ended June 30, 2011 and 2010 were \$321K and \$395K, respectively.

MSF is allowed by Montana Constitution to invest in equity securities, with the restriction that equity securities cannot exceed 25% of total investment book value. The BOI policy for MSF maintains equities in the 8% to 12% range. As of June 30, 2011, equity securities in MSF include \$99.0M at cost, increased by \$38.5M in market value appreciation. As of June 30, 2010, equity securities in MSF include \$102.4M at book value, increased by \$8.4M in market value appreciation. Additional investment information can be found in Note 2.

Receivables

At June 30, 2011, MSF had a net receivable balance of \$58.1M. The billed premium receivable and claim benefit recoveries balance is \$9.7M, which is then reduced by the estimated uncollectible receivables reported as an allowance for doubtful accounts of \$2.7M. Other receivables include \$39.0M in unbilled premium, \$11.2M in investment income due, \$740K in retrospective premium and \$201K in notes and loans receivable, all of which are short term.

At June 30, 2010, MSF had a net receivable balance of \$64.0M. The billed premium receivable and claim benefit recoveries balance is \$10.1M, which is then reduced by the estimated uncollectible receivables reported as an allowance for doubtful accounts of \$2.5M. Other receivables include \$44.7M in unbilled premium, \$10.7M in investment income due, \$762K in retrospective premium and \$196K in notes and loans receivable, all of which is short term.

Accounts receivable includes \$3.4M at June 30, 2011 and \$691K at June 30, 2010 for premium that has been earned but unbilled (EBUB).

Equipment, Accumulated Depreciation and Intangible Assets

Equipment is capitalized if the actual or estimated historical cost exceeds \$5K. Depreciation expense is computed on a straight-line basis for equipment over a period of three to five years and amortization of intangible assets is computed on a straight-line basis over five years. Amortization of intangible assets is applied directly to the asset balance. All fixed assets are recorded in the MSF financials and shown net of depreciation.

Other Assets

Other assets include advances, prepaid expenses and deferred acquisition costs. Deferred acquisition costs are amounts incurred during the policy writing process that are recognized ratably over the related policy term.

During June of 2010, MSF completed construction of an office building that it now occupies. MSF pays all costs of the property including utilities, property assessments, janitorial services, and maintenance. For the fiscal year ended June 30, 2011, MSF financial statements include $1.14M in land and $27.4M in buildings, net of depreciation. For the fiscal year ended June 30, 2010, MSF financial statements include $1.14M in land and $27.8M in buildings, net of depreciation. Prior to occupying the new building, MSF leased an office building from the State of Montana and other office space in Helena. That lease expired on July 31, 2010.

Estimated Claims Payable

The estimated claims payable is established to provide for the estimated ultimate settlement cost of all claims incurred. Estimated claims payable is based on reported aggregate claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported (IBNR) claims. Towers Watson, an external actuarial firm, prepares an actuarial study that provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected central estimates within that range as the estimated claims payable for MSF. For additional disclosure related to the estimated claims payable, refer to Note 4.

Accounts Payable

Accounts payable is a short term liability account reflecting amounts owed for goods and services received by MSF.

Unearned Premium

Unearned premium reflects premium that has been written but not yet earned. The unearned premium was $37.4M and $47.1M at June 30, 2011 and 2010, respectively.

Policyholder Deposits

Policyholder deposits consist of security deposits owed to policyholders that are required to have a deposit policy and secure the policy with cash, letter of credit or certificate of deposit.

Reinsurance Funds Withheld

Reinsurance funds withheld represents the reinsurance funds held on behalf of the reinsurer, a requirement of MSF's aggregate stop loss reinsurance contract. Additional information regarding the funds withheld account can be found in Note 3.

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Net Assets

Net assets consist of the net excess or deficit of assets over liabilities. For additional information on distributions impacting total net assets see Note 7.

Premiums

The MSF Board of Directors approves premium rates annually. Generally, policies are effective for the term of the policy period not to exceed 12 months. Premium revenue is recognized over the term of the fiscal year, which runs from July 1 through June 30, as it is earned or when MSF is liable for coverage.

Policyholders are contractually obligated to pay certain premiums to MSF in advance of the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is canceled and all earned premiums have been credited by MSF.

Basis of Presentation

The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the GASB. MSF insurance operations are classified as an enterprise fund, proprietary fund type. MSF comprises only a part of the State of Montana's enterprise funds. The financial statements in this report reflect the financial position and results of operations and cash flows of MSF.

An enterprise fund is used to account for operations: (a) financed and operated in a manner similar to private business enterprises, where the legislature intends that the entity finance or recover costs primarily through user charges; (b) where the legislature has decided that periodic determination of revenues earned, expenses incurred or net income is appropriate; (c) where the activity is financed solely by a pledge of the net revenues from fees and charges of the activity; or (d) when laws or regulations require that the activities' costs of providing services be recovered with fees and charges rather than with taxes or similar revenues.

In fiscal year 2011 a reporting entity change resulted in the Old Fund financial statement presentation being removed from these financial statements. In fiscal year 2010 the Old Fund financial statements were reported as a component unit of the State of Montana. The Old Fund assets were completely liquidated during fiscal year 2011 and based on state law the General Fund assumed responsibility for claim benefit payments beginning in June 2011.

Investments are presented in accordance to GASB Statement Number 31, "Accounting and Financial Reporting for Certain Investments and External Investment Pools." STIP is considered an external investment pool, which is defined as an arrangement that pools the monies of more than one legally separate entity and invests, on the participant's behalf, in an investment portfolio. STIP is also classified as a "2a7-like" pool. A 2a7-like pool is an

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external investment pool that is not registered with the Securities and Exchange Commission (SEC) as an investment company, but has a policy that it will, and does, operate in a manner consistent with the SEC's Rule 2a7 of the Investment Company Act of 1940. If certain conditions are met, 2a7-like pools are allowed to use amortized cost rather than fair value to report net assets to compute unit values. The BOI has adopted a policy to treat STIP as a 2a7-like pool. See Note 1, Basis of Accounting – Investments and Note 2 for further discussions of the effect of GASB 31.

2. Investments

The amortized cost and market value of MSF's fixed maturity and equity securities as of June 30, 2011, and 2010, is as follows:

		Gross Unrealized		
June 30, 2011	Amortized Cost	Gain	Loss	Market Value
Government Direct-Indirect	$ 365,213,387	$ 27,810,308	$ 91,941	$ 392,931,754
Government Mortgage-Backed	25,304,778	1,928,853	-	27,233,631
Corporate Securities Asset-Backed	38,775,014	1,618,879	2,500,121	37,893,772
Other Corporate Securities	571,993,354	35,479,956	173,137	607,300,173
Other Securities	257,158	-	-	257,158
Equity Securities	99,007,538	38,524,702	-	137,532,240
STIP	14,889,039	-	-	14,889,039
Total	$ 1,115,440,268	$ 105,362,698	$ 2,765,199	$ 1,218,037,767

		Gross Unrealized		
June 30, 2010	Amortized Cost	Gain	Loss	Market Value
Government Direct-Indirect	$ 351,190,011	$ 28,435,572	$ -	$ 379,625,583
Government Mortgage-Backed	39,680,185	2,860,876	-	42,541,061
Corporate Securities Asset-Backed	54,542,436	2,330,402	2,554,874	54,317,964
Other Corporate Securities	482,296,988	31,761,806	377,784	513,681,010
Other Securities	1,460,026	-	-	1,460,026
Equity Securities	102,406,677	8,570,072	186,560	110,790,189
STIP	22,753,534	-	-	22,753,534
Total	$ 1,054,329,856	$ 73,958,728	$ 3,119,218	$ 1,125,169,366

The amortized cost and estimated market value of MSF's fixed maturity securities as of June 30, 2011 and 2010 are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

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	Amortized Cost	Market Value
Due one year or less	$ 115,606,564	$ 117,099,694
Due after one year through five years	503,464,929	529,533,293
Due after five years through ten years	358,522,151	392,569,766
Due after ten years	38,839,086	41,302,774
Equity Securities	99,007,538	137,532,240
Total	$ 1,115,440,268	$ 1,218,037,767

June 30, 2010

	Amortized Cost	Market Value
Due one year or less	$ 90,335,353	$ 91,940,611
Due after one year through five years	462,617,747	486,053,179
Due after five years through ten years	343,845,184	377,809,278
Due after ten years	55,124,896	58,576,110
Equity Securities	102,406,677	110,790,189
Total	$ 1,054,329,856	$ 1,125,169,366

During the fiscal year ending June 30, 2011, MSF realized gross gains from sales of securities of $6.5M and gross realized losses of ($55K). During the fiscal year ending June 30, 2010, MSF realized gross gains from sales of securities of $2.8M and gross realized losses of ($663K).

As discussed in Note 1, GASB 31 requires governmental entities to report their investments at fair value. Fair value is defined as the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The adjustment to fair value is reflected as an increase or decrease in investment income. During fiscal year 2011, investment income for MSF was $81.1M including an unrealized gain on investments in the amount of $31.8M. Investment income for fiscal year 2010 was $120.5M including an unrealized gain on investments of $74.0M.

3. Reinsurance

For the fiscal years ended June 30, 2011 and 2010, MSF ceded premiums to other reinsurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts that protect against individual occurrences over stipulated amounts and an aggregate stop loss contract which protects MSF against the potential that aggregate losses will exceed expected levels expressed as a percentage of premium.

The excess of loss contract provides coverage up to $100 million in which MSF retains the

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first $5 million for the first layer of reinsurance coverage. The excess of loss protection applies to an individual occurrence with the maximum of $5 million on any one life. The excess of loss contracts coverage for fiscal years 2011 and 2010 is as follows:

Contract Period	Reinsurance Coverage
2011	Workers' compensation accidents of up to $5M in excess of $5M, maximum of $5M per any one claimant.
	Workers' compensation accidents of up to $20M in excess of $10M, maximum of $5M per any one claimant.
	Workers' compensation accidents of up to $70M in excess of $30M, maximum of $5M per any one claimant.
2010	Workers' compensation accidents of up to $5M in excess of $5M, maximum of $5M per any one claimant.
	Workers' compensation accidents of up to $20M in excess of $10M, maximum of $5M per any one claimant.
	Workers' compensation accidents of up to $70M in excess of $30M, maximum of $5M per any one claimant.

The term of the current aggregate stop loss contract is July 1, 2008 through June 30, 2011. The contract provides coverage based on MSF's premium levels, not to exceed 15% of the subject net earned premium. In the event reinsurers are unable to meet their obligations under either the excess of loss contracts or aggregate stop loss contract, MSF would remain liable for all losses, as the reinsurance agreements do not discharge MSF from its primary liability to the policyholders.

Premium revenue is reduced by premiums paid for reinsurance coverage of $11.3M and $13.2M in fiscal years 2011 and 2010, respectively. The aggregate stop loss contract requires that MSF maintain a funds-withheld account which represents the basic premium portion of the total premium paid for aggregate stop loss coverage. The total funds withheld account at June 30, 2011 is $57.9M for contracts in place from July 1, 2002 to June 30, 2011. The funds withheld account at June 30, 2010 was $64.2M for contracts in place from July 1, 2002 to June 30, 2010. Interest must be accrued on the funds withheld account which resulted in accrued interest of $2.9M for fiscal year 2011 and $3.2M for fiscal year 2010.

Estimated claim reserves were reduced by $8.0M and $7.4M for fiscal years 2011 and 2010 respectively for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the excess of loss reinsurance contract. In fiscal year 2011, the estimated claim reserves were reduced by an additional $21.2M and in fiscal year 2010 an additional $12.0M for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the aggregate stop loss contract.

MSF also has assumed reinsurance relationships with Zurich American Insurance Company, Argonaut Insurance Company and Legion Insurance Company related to Other States Coverage (OSC). MSF assumes risk related to Montana domiciled businesses with operations in other states, which are then covered under MSF's ceded reinsurance contract. Assumed premium for fiscal years 2011 and 2010 is $1.8M and $1.6M, respectively. The incurred losses from OSC benefits were $610K and $453K for fiscal years 2011 and 2010, respectively. The assumed liability for OSC claims is $4.8M and $5.2M for fiscal years 2011 and 2010, respectively.

4. Risk Management

MSF provides liability coverage to employers for injured employees that are insured under the Workers' Compensation and Occupational Disease Acts of Montana. Workers' compensation claims occurring on or after July 1, 1990, are reported in the MSF financials. At June 30, 2011, approximately 24,780 active policies were insured by MSF. At June 30, 2010, approximately 25,253 active policies were insured by MSF.

MSF is a self-supporting, competitive state fund and functions as the guaranteed market insurer for employers since workers' compensation insurance is mandatory in Montana. Employers may obtain coverage through private carriers, through MSF or through self-insurance if they meet certain criteria. Public entities may self-insure or insure through MSF.

Montana State Fund serves as claim administrator on claims for injuries that occurred before July 1, 1990, known as the State of Montana (Old Fund). Unpaid claims and claim adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other social and economic factors.

Towers Watson, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2011 and 2010. Because actual claim costs depend on such complex factors such as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors. A provision for inflation is implicit in the calculation of estimated future claim costs because reliance is placed both on actual historical data that reflects past inflation and on other factors that are considered to be appropriate modifiers of past experience.

Towers Watson provides a range of potential costs associated with reported claims, the

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future development of those claims and IBNR. MSF management has selected a central estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2011 and 2010. The MSF estimated unpaid claims and claims adjustment expenses payable is presented at face value, net of estimated reinsurance recoverable, at $874.8M and $838.8M, as of June 30, 2011 and 2010, respectively. The estimated claims payable increased $36.0M from 2010 to 2011, which includes additional development of approximately $2.3M on prior year claims and an increase of $15.9M as a result of higher loss adjustment expenses. MSF currently has no knowledge of any significant environmental or asbestos claims that would contribute to this estimate.

State law (Section 39-71-2311, MCA) requires MSF to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. Anticipated investment income is considered when computing premium rate levels. State law also requires the MSF Board of Directors to establish surplus above risk based capital requirements to secure MSF against risks inherent in the business of insurance.

Acquisition costs represent costs associated with the acquisition of new insurance contracts or renewal of existing contracts and include agent commissions and expenses incurred in the underwriting process. MSF acquisition costs are capitalized and amortized ratably over the subsequent year. Capitalized acquisition costs at June 30, 2011 and 2010 are $4.2M and $4.4M, respectively.

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Changes in Claims Liabilities for the Past Two Years

The following table presents changes in the aggregate liabilities for MSF for the past two years, net of estimated reinsurance recoverable. The information presented has not been discounted.

	2011	2010
Unpaid claims and claim adjustment expenses at beginning of year	$ 838,765,340	$ 813,304,712
Incurred claims and claim adjustment expenses:		
Provision for insured events of the current year	143,337,473	144,893,281
Increase(Decrease) in provision for events in prior years	7,323,174	8,201,572
Total incurred claims and claim adjustment expenses	150,660,647	153,094,853
Payments:		
Claims and claim adjustment expenses attributable to insured events of CY	(27,923,613)	(25,477,518)
Claims and claim adjustment expenses attributable to insured events of PY	(86,699,490)	(102,156,707)
Total payment	(114,623,103)	(127,634,225)
Total unpaid claims and claim adjustment expenses at end of the year	$ 874,802,884	$ 838,765,340

5. Administrative Cost Allocation

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to $1.25M. MSF allocated $941K and $955K in administration costs to the Old Fund in fiscal years 2011 and 2010, respectively. Beginning in June 2011, the State of Montana General Fund began making transfers to cover the cost of administering the Old Fund claims. These transfers are recorded as non-operating revenue as a payment from the General Fund.

6. MSF Distributions

During the fiscal year ended June 30, 2011, the MSF Board of Directors authorized a dividend to policyholders. MSF paid dividends to eligible policyholders in the amount of $4.0M for the policy year 2008. The MSF Board of Directors authorized and MSF paid a dividend of $2.0M in fiscal year 2010 for policy year 2007.

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7. Compensated Absences

MSF supports two leave programs, the State of Montana Leave Program, (Traditional Plan) and the MSF Personal Leave Program, implemented in January 2002. The State of Montana Leave Program covers union represented employees who have elected to remain in the plan. These employees accumulate both annual leave and sick leave and MSF pays employees 100% of unused annual leave and 25% of unused sick leave upon termination. MSF also pays 100% of unused compensatory leave credits upon termination to non-exempt employees in the Traditional Plan. MSF Personal Leave Program covers all non-union employees, union employees hired before July 26, 2006 who have elected to adopt the plan, and all employees hired after July 25, 2007. Employees in the Personal Leave Program accumulate personal leave and extended leave. MSF pays employees for 100% of unused personal leave upon termination but extended leave has no cash value at the time of termination.

The total compensated absences liability for MSF is \$2.7M and \$2.6M at June 30, 2011 and 2010, respectively.

8. Retirement Plans

MSF and its employees contribute to the Public Employees' Retirement System (PERS), which offers two types of retirement plans administered by the Public Employees' Retirement Board (PERB). The first plan is the Defined Benefit Retirement Plan (DBRP), a multiple-employer, cost-sharing plan that provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on eligibility, years of service and highest average compensation. Vesting occurs once membership service totals five years. Benefits are established by state law and can only be amended by the legislature.

The second plan is the Defined Contribution Retirement Plan (DCRP), created by the 1999 legislature and available to all active PERS members effective July 1, 2002. This plan is a multiple-employer, cost-sharing plan that also provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on the balance in the member's account, which includes the total contributions made, the length of time the funds have remained in the plan, the investment earnings less administrative costs.

Eligible PERS members choose to participate in either the DBRP or DCRP but may not be active members of both plans. MSF employees hired prior to July 1, 2011 are required to contribute 6.9% of annual compensation in fiscal years 2011 and 2010. Employee's hired on or after July 1, 2011 is required to contribute 7.9%. The employer (MSF) is required to contribute 7.17% of annual compensation in fiscal years 2011 and 2010 regardless of the hire date of the employee. MSF's contributions amounted to \$1.3M and \$1.2M for fiscal years 2011 and 2010, respectively. MSF and its employees paid one hundred percent of required contributions to PERS and there is no unpaid liability as of June 30, 2011.
The PERS financial information is reported in the Public Employees' Retirement Board

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Comprehensive Annual Financial Report for the fiscal year-end. This information is available from PERB at 100 North Park Avenue, Suite 220, P.O. Box 200131, Helena, MT 59620-0131, (406) 444-3154.

MSF and its employees are eligible to participate in the State of Montana Deferred Compensation Plan (457 plan) administered by the PERB. The Deferred Compensation plan is a voluntary, tax-deferred retirement plan designed as a supplement to other retirement plans. Under the plan, eligible employees elect to defer a portion of their salary until future time periods. MSF incurs no costs for this plan.

9. Leases and Commitments

MSF leases office facilities outside of Helena under various operating leases that expire through December 2015. Rental expense for fiscal years 2011 and 2010 was $304K and $314K, respectively.

MSF leases 350 parking spaces in a parking garage that was built by the City of Helena adjacent to the MSF facility that expires June 30, 2040. The cost of the parking spaces will be the same monthly rate as equivalent parking passes sold by the city. The parking facility opened in conjunction with the move to the new building in June 2010. The annual subsequent parking cost is estimated to be $235K with potential to change based on parking rates assigned by Helena Parking Commission.

The future minimum rental payments are as follows:

Fiscal Year	Amount
2012	$ 271,705
2013	269,352
2014	260,394
2015	235,953
2016	235,200
Thereafter	5,644,800
	$ 6,917,404

10. Other Post-Employment Benefits (OPEB)

Beginning with the fiscal year ending June 30, 2008, the State of Montana implemented Governmental Accounting Standards Board (GASB) Statement 45, Accounting and Financial Reporting by Employers for Post-employment Benefits Other Than Pensions. This statement requires the disclosure of employer liability for retiree medical subsidies and other post-employment benefits. The OPEB liability at June 30, 2011 and 2010 was $3.4M and $2.6M respectively.

Post-employment Healthcare Plan Description:

MSF employees and dependents are eligible to receive health care through the State Group Benefits Plan administered by the Montana Department of Administration. In accordance with section 2-18-704, MCA, the State provides optional post-employment medical, vision and dental health care benefits to the following employees and dependents who elect to continue coverage and pay administratively established premiums: (1) employees and dependents who retire under applicable retirement provisions and (2) surviving dependents of deceased employees. For GASB 45 reporting, the State Group Benefits Plan is considered an agent multiple-employer plan and MSF is considered to be a separate employer participating in the plan.

In addition to the employee benefits described in Note 9 Retirement Plans, the following post-employment benefits are provided. Montana Department of Administration established retiree medical premiums vary between $285 and $982 per month depending on the medical plan selected, family coverage, and Medicare eligibility. Administratively established dental premiums vary between $34.90 and $59.36; vision premiums vary between $7.64 and $22.26; both premiums vary depending on the coverage selected. Basic life insurance in the amount of $14,000 is provided until age 65 at a cost of $2.10 per month to the retiree. The State Benefit Plans reimburse all validated medical claims net of member obligations (annual deductibles and coinsurance of the members' selected medical plan). Dental claims are reimbursed at 50% to 100% of the allowable charges, depending on the services provided. The State acts as secondary payer for retired Medicare-eligible claimants.

Benefits Not Included in the Valuation:

Retirees pay 100 percent of dental premiums. The vision benefit is fully-insured and retirees pay 100 percent of the cost. Thus, there is no liability for dental or vision valued in this valuation. The life insurance benefit is a fully-insured benefit that is payable until age 65 with the retiree required to pay the full premium. There is no liability valued in this valuation for the retirees, though the required premium is an active/retiree blended premium. This liability would be insignificant to the overall results of this valuation.

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Funding Policy:

The following estimates were prepared based on an actuarial evaluation prepared as of the year ending December 31, 2009 for the Department of Administration and the resulting State of Montana Actuarial Valuation of Other Post-Employment Benefits Plan (plan) contains the MSF data and is available through:

Montana Department of Administration
State Accounting Division
Room 255, Mitchell Bldg.
125 N Roberts St
PO Box 200102
Helena, MT 59620-0102

GASB 45 requires the plan's participants, including the MSF, to report each year the annual required contribution (ARC), an amount actuarially determined in accordance with the parameters of GASB Statement 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year of retiree health care costs and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years. The 2009 ARC is calculated for all the State plan's participants and then individually allocated to individual participants. The MSF 2011 allocated portion of the ARC is estimated at $874K and is based on the plan's current ARC rate of 6.45% percent of participants' annual covered payroll. The MSF 2011 ARC is equal to an annual amount required each year to fully fund the liability over thirty years.

The amount of the estimated OPEB actuarial accrued liability at transition was determined in accordance with the GASB Statement 45, and liability is estimated at $8.0M for MSF. The actuarial accrued liability is the present value of future retiree and active employees who will retire and be eligible for benefits and expenses.

Actuarial Methods and Assumptions:

Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations. Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and the healthcare cost trend. Amounts determined regarding the funded status of the plan and the annual required contributions of the employer are subject to continual revision as actual results are compared

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with past expectations and new estimates are made about the future. The schedule of funding progress, presented as required supplementary information following the notes to the financial statements, presents information that shows the actuarial value of plan assets and liabilities. In the December 31, 2009, actuarial valuation, the projected unit credit funding method is used. The actuarial assumptions did not include an investment rate of return since no assets meet the definition of plan assets under GASB 43 or 45. Annual healthcare cost trend rates of 10 percent for medical and 9.5 percent for prescription claims are used. The unfunded actuarial accrued liability is amortized following a 30-year level percent of pay amortization on an open basis, using a 4.25 percent discount rate and a 2.50 percent payroll growth rate assumption.

The State finances claims on a pay-as-you-go basis and does not advance-fund the OPEB liability. While this liability is disclosed for financial statement purposes it does not represent a legal liability of the State of Montana or MSF. Therefore, the following cost information shows no value for Plan Assets made by MSF.

Annual Other Post Employment Benefits (OPEB) Cost:

MSF's allocated annual OPEB cost (expense) for year ending June 30, 2011 was $812K. The interest on the net OPEB obligation for year ending June 30, 2011 was $31K. For fiscal year 2010, MSF's allocated annual OPEB cost (expense) was $770K and the interest was $38K.

The MSF annual OPEB cost, the percentage of annual OPEB cost contributed to the plan and the net OPEB obligation for 2011 and prior are as follows:

Fiscal Year Ended	Annual OPEB Cost	Percentage of Annual OPEB Cost Contributed	Net OPEB Obligation
6/30/2008	858,215	0.00%	858,215
6/30/2009	894,689	0.00%	1,752,904
6/30/2010	808,837	0.00%	2,561,741
6/30/2011	843,212	0.00%	3,404,953

Funded Status and Funding Progress:

The most recent actuarial valuation available that was completed by the State of Montana was as of January 1, 2009 for the year ending December 31, 2009. This actuarial evaluation is completed every two years with the next valuation to be completed as of January 1, 2011 for the year ending December 31, 2011.

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The MSF allocation of the plan as of the year ending December 31, 2009 was as follows:

Actuarial Accrued Liability (AAL)	$6,985,326
Actuarial Value of Plan Assets	$0
Unfunded Actuarial Accrued Liability (UAAL)	$6,985,326
Funded Ratio (Actuarial Value of Plan Assets/AAL)	$0
Covered Payroll (Active Plan Members)	$16,766,753
UAAL as a Percentage of Covered Payroll	41.66%

11. Contingencies

Coles, Individually and as Personal Representatives for the Estate of Steven Bearcrane v. Black Ranches, Inc., Crow Tribal Court No. CAV 07-044, is a tort case filed against a policy holder of Montana State Fund. The case involves a wrongful death claim by the estate of an employee of the policyholder. Montana State Fund is providing a defense under a complete reservation of rights to the policy holder under Part Two of the State Fund's insurance policy, also known as employer's liability coverage. The policy limits in this case are $1,000,000. The exclusive remedy provisions of MCA Section 39-71-411 should bar this type of tort claim against the policy holder. However, if the plaintiffs are successful in convincing the court that MCA Section 39-71-411 does not provide a defense, and that the employer-policyholder was at fault in causing the death of its employee, the damages may be substantial. The case was dismissed at the Crow Tribal Court level on the grounds that the tribal court did not have jurisdiction, and was then appealed to the Crow Tribal Appellate Court. The Crow Tribal Court dismissed the appeal. There is a possibility of further legal action in this case. The actual potential cost impact to the State Fund is not known at this time. Liability for Montana State Fund, up to its policy limits ($1,000,000), is possible.

Victory Insurance Company, Inc. v. Montana State Fund et al. Victory filed its Amended Complaint in this action on March 29, 2011, in which it asserts various tort claims against Montana State Fund. A Motion to Dismiss was filed on May 11, 2011 asserting the District Court lacked jurisdiction to hear the matter, as Victory failed to first submit an administrative claim to the Department of Administration. No specific amount of damages were stated in the complaint. The actual potential cost impact to the State Fund is not known at this time. Montana State Fund does not have sufficient information to determine potential liability or cost impact.

Montana State Fund also is involved in a great deal of litigation in the areas of workers' compensation and disputes with policyholders. These are of a generally routine nature and there are no known matters at this time that will have a large and widespread financial impact.

REQUIRED SUPPLEMENTARY INFORMATION

Other Post-Employment Benefits (Financial Statement Note 11)

As of June 30, 2011, the most recent actuarial valuation available that was completed by the State of Montana was as of January 1, 2009 for the year ending December 31, 2009. This actuarial evaluation is completed every two years with the next valuation to be completed as of January 1, 2011 for the year ending December 31, 2011.

The State of Montana finances claims on a pay-as-you-go basis and does not advance fund the OPEB liability. Therefore, the funded ratio remains at 0% at June 30, 2011.

SCHEDULE OF FUNDING PROGRESS

Date	Actuarial Value of Assets (A)	Actuarial Accrued Liability (AAL) (B)	Unfunded AAL (UAAL) (B-A)	Funded Ratio (A/B)	Covered Payroll (C)	UAAL as a Percentage of Covered Payroll (B-A)/C)
1/1/2007	$0	$8,079,405	$8,079,405	0.00%	$16,805,676	48.08%
1/1/2009	$0	$6,985,326	$6,985,326	0.00%	$16,766,753	41.66%

Risk Management

The following table illustrates how the earned revenues of MSF plus investment income compare to related costs of loss and other expenses assumed by MSF for fiscal years 2002 through 2011. In addition, cumulative amounts related to estimated and actual paid claims are presented. The information allows for comparison of actual and estimated claims and is a basis for developing revenue and claims information. As data for individual policy years mature, the correlation between original estimates and re-estimated amounts is used to evaluate the accuracy of incurred claims currently recognized for less mature policy years.

Risk Management Trend Information

(In Thousands)	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
1. Premiums and Investment Revenue										
Earned	126,533	166,477	175,586	235,620	258,165	296,703	279,758	245,234	205,916	196,386
Ceded	(465)	5,654	6,563	6,788	13,618	14,856	14,676	13,702	13,224	11,286
Net Earned	126,997	160,823	169,023	228,832	244,548	281,847	265,082	231,532	192,692	185,099
2. Unallocated expenses including overhead	28,713	31,548	37,569	39,078	40,548	41,947	47,778	49,215	44,188	57,282
3. Estimated losses and expenses, end of accident year										
Incurred	81,560	110,153	120,705	134,290	155,057	170,652	177,100	159,229	137,507	142,989
Ceded	-	-	-	-	-	-	-	-	-	9,769
Net Incurred	81,560	110,153	120,705	134,290	155,057	170,652	177,100	159,229	137,507	133,220
4. Net paid (cumulative) as of:										
End of policy year	16,693	22,982	26,123	25,721	30,977	32,708	31,002	29,009	25,475	27,902
One year later	38,185	48,861	50,888	57,239	66,063	67,928	67,034	60,009	52,701	
Two years later	52,359	63,773	66,140	72,229	84,014	85,646	86,268	74,132		
Three years later	60,029	72,957	74,697	82,647	94,091	98,427	95,612			
Four years later	64,922	79,060	80,233	88,236	100,189	104,967				
Five years later	68,343	84,340	83,788	93,682	105,815					
Six years later	71,566	88,645	86,707	96,539						
Seven years later	74,253	89,482	89,038							
Eight years later	75,036	92,167								
Nine years later	76,698									
5. Re-estimated ceded losses and expenses	-	8,600	2,805	-	-	-	-	-	-	9,769
6. Re-Estimated net incurred losses and expense:										
End of policy year	81,560	110,153	120,705	134,290	155,057	170,652	177,100	159,229	137,507	133,220
One year later	86,799	110,532	112,609	136,235	157,711	171,783	174,279	152,886	139,554	
Two years later	91,241	112,443	124,413	138,447	163,433	170,786	173,808	151,738		
Three years later	94,615	117,245	127,827	144,484	164,358	172,038	172,888			
Four years later	99,755	115,414	129,051	143,820	165,313	171,987				
Five years later	100,925	119,976	127,702	145,839	164,613					
Six years later	105,651	121,686	127,054	145,031						
Seven years later	104,874	120,020	126,979							
Eight years later	103,261	120,296								
Nine years later	103,646									
7. Increase (decrease) in estimated net incurred losses and expenses from end of policy year	22,086	10,143	6,274	10,741	9,556	1,335	(4,211)	(7,491)	2,047	-

MONTANA STATE FUND

STATE FUND RESPONSE

MONTANA STATEFUND

855 Front Street • P.O. Box 4759 • Helena, MT 59604-4759
Customer Service: 800-332-6102 or 406-495-5000
Fax 406-495-5020 - TDD/TTY 406-495-5030
Fraud Hotline: 888-682-7463 (888-MT-CRIME)
www.montanastatefund.com

December 2, 2011

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DEC 05 2011
LEGISLATIVE AUDIT DIV.

Ms. Tori Hunthausen
Legislative Audit Division
Room 160, State Capitol
Helena, MT 59620-1705

Dear Ms. Hunthausen:

Montana State Fund appreciates the professionalism of the Legislative Audit Division staff involved in the audit of our governmental financial statements. Once again, we are pleased with your issuance of an unqualified opinion without any audit recommendations on the financial statements presented.

The management and staff of MSF are very proud of our accomplishments in serving Montana businesses. We continually strive to improve our operations to ensure Montana businesses and the community will benefit from a strong Montana State Fund many years into the future. Thank you for your assistance and assurance.

Sincerely,

Laurence Hubbard
President/CEO